EXHIBIT 3
(Reply Declaration of Professors Janusz A. Ordover and Robert D. Willig)

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
AT&T Corp.	)	
	)	RM 10593
Petition for Rulemaking To Reform Regulation of Incumbent Local Exchange Carrier Rates For Interstate Special Access Services	)	

REPLY DECLARATION OF
JANUSZ A. ORDOVER AND ROBERT D. WILLIG
ON BEHALF OF AT&T CORP.

I. INTRODUCTION AND SUMMARY.

1. In our initial declaration, we explained why the Commission's existing regulatory scheme has not prevented the Bells from exercising market power over special access services. The reasons for this are straight-forward. In the vast majority of relevant local markets, special access customers simply have no choice but the Bells for last mile high capacity channel terminations and transport. In a narrow minority of relevant local markets it is true that competitive carriers have deployed facilities (primarily high capacity optical transport) on some routes (primarily connecting the largest downtown buildings) in selected areas (primarily the most dense urban corridors). Those facilities are far too sparse to enable the interexchange carriers ("IXCs") (or other carriers) to obtain access to the vast majority of end-user customers who are located in buildings served only by the Bells.

2. In principle, properly calibrated regulations could distinguish between those geographic locations where effective price-constraining competition exists and those where it does not.

It is now clear, however, that the Commission's existing rules do not do so. First, the Commission's regulations lift pricing regulation over channel terminations when, at most, there is only competition in the provision of transport facilities. Because IXCs need both inputs to access end-user customers, even where the Bells face transport competition they can nonetheless exercise market power by charging supracompetitive prices for their channel termination. Second, the Commission's regulations grant MSA-wide relief even where only a small fraction of customer locations in the MSA have competitive alternatives. Thus, the Bells' special access rates are deregulated even for locations and routes where they face *no* competition at all. Third, the Commission deregulated DSn level special access services based solely on evidence that competitive carriers had deployed OCn level facilities that are ordinarily not deployed to provide DSn level services.

3. This lack of competition or meaningful regulatory oversight has had predictable consequences. However reasonable the Commission's predictive judgment that its triggers were properly constructed, by all accepted measures, where the Bells have been granted pricing freedom, the effect has been exercise of market power and supracompetitive prices for special access. While the unit costs of special access have continued to decline – due both to efficiency gains in fiber electronics technology and the combination of scale economies and increased demand – the Bells have significantly raised special access rates where they have received Phase II pricing flexibility. In no instance have the Bells lowered their special access rates. In fact, the Bells' tariffed special access rates for all MSAs where they have been granted pricing flexibility are *higher* than in those MSAs where they continue to be subject to price cap regulation. As a result of these price increases and cost

decreases, the Bells' special access rates are now generally two to four times greater than the economic costs of providing the underlying loop and transport facilities.

4. Notably, although the *raison-d'être* of the *Pricing Flexibility Order* was to give the Bells the ability to lower prices in order to meet emerging competition, the Bells have chosen not even to respond to those limited pockets of competition that have developed. Use of contract tariffs is almost non-existent. Where they have deployed facilities, competitive carriers offer attractive rates and service quality commitments that the Bells do not even attempt to match.

5. Where competition is confined to only a limited portion of the discrete locations in an MSA, such behavior is to be expected. The Bells understand that if they reduce rates to meet competition in part of the MSA, customers in other parts of the MSA will demand similar reductions, citing the Communication Act's prohibition against unreasonable discrimination. Given these disincentives to price discriminate, the Bells' best strategy is to keep rates high throughout the MSA, even if that means losing some customers in the MSA on the relatively few routes that face effective competition. This is a reflection of the barriers to entry and to expansion that keep competitive carriers from offering effective competition in the rest of the MSA. Opportunities for facilities-based entry and expansion to offer timely competition are further constricted by means of the Bells' long term deals with stiff termination penalties that carriers have to accept in order to obtain a discount from the Bells' exorbitantly priced month-to-month offerings, as well as Bells' "exclusive" arrangements that prevent carriers from sending anything more than a token amount of traffic to competitive carriers.

6. Allowing the Bells to exercise market power in special access imposes public interest harms well beyond the billions of dollars of monopoly rents that they currently collect from carriers and, ultimately, from consumers. The Bells' charges distort the proper allocation of resources and reduce investment by many local, long distance, wireless and broadband companies that must use special access to provide finished telecommunications services to end-users. And, perhaps most importantly for this Commission, excessive special access rates give the Bells the ability to foreclose competition in downstream retail markets.

7. Relying on a declaration by Dr. Alfred Kahn and Dr. William Taylor, the Bells challenge the notion that they exercise market power in the provision of special access. Notably, however, Kahn and Taylor do not dispute the reasonableness of the criteria we have identified to judge whether market power exists. Nor do Kahn and Taylor attempt to demonstrate that the Bells, in fact, lack power in any relevant market. Rather, their principal response is that the factual evidence used by AT&T to support its showing is flawed and cannot be relied upon.

8. Kahn and Taylor's criticisms of AT&T's evidence are not well founded. At the end of the day, on the critical issue of the availability of bypass facilities in the relevant local markets, Kahn and Taylor offer only "national" statistics that do not even purport to show the existence of actual alternatives in the vast majority of the relevant local markets. The uncontradicted evidence of record shows that IXCs, CMRS providers and other carriers have no option but the Bells to gain access to the overwhelming majority of end-use buildings and businesses. Nor do Kahn and Taylor deny that the Bells have generally increased prices where they have been granted special access pricing flexibility. They suggest that these price increases can be explained as a result of increases in demand, but

because of economies of scale, increased usage of Bell last mile facilities would lead to *lower* per unit costs, without general upward pressure on marginal costs. Thus, rather than supporting their own conclusions, Kahn and Taylor's argument actually supports our findings that Bells have been exercising market power. And although Kahn and Taylor are correct that as between accounting and economic costs evidence, economic costs are the superior measure, they fail to recognize that AT&T's accounting cost evidence provides a conservative estimate of Bell earnings and, more fundamentally, that the evidence shows that Bells' special access rates exceed by several times any reasonable measure of economic costs. *See infra* Part II.

9. Kahn and Taylor also misconstrue our complaint about the Bells' optional pricing plans ("OPPs"). The fact that these OPPs are generally available does not mean that they can have no negative impact on the development of competition. Rather, the public policy issue here is that the Bells present carriers with only two choices: excessively priced month-to-month rates or long term OPPs with discounts off the month-to-month rate. To be sure, if the month-to-month rate were established in an effectively competitive market, the general availability of a lower contractual rate, even one that required a sizeable term and/or volume commitment, could not be considered to be harmful to competition. But here, where the Bells' market positions stem from years of monopoly sanctioned by regulation, resulting in base rates that are now far above costs, IXCs may be impelled to choose onerous term and exclusivity conditions because the alternative month-to-month rate is so high *and* there are no competitively viable alternatives in a vast majority of relevant markets. And by tying up the largest special access purchasers (IXCs) through, these long-term deals, some of which require purchasers to use the Bells for virtually all of their

special access needs, the Bells can impede competitive carriers from timely gaining the revenues that they need to build alternative networks, thereby magnifying the impacts of otherwise high barriers to entry and frustrating the public policy objectives of creating and enhancing competition in the provision of special access. *See infra* Part III.

10. Finally, Kahn and Taylor are wrong in claiming that the Bells lack the incentive or ability to use special access market power either to foreclose local competition or to gain power in downstream long distance and wireless markets. Most of their arguments are tautological – *i.e.*, they are premised on the incorrect notion that the Bells lack special access market power and therefore have no market power to leverage. And to the extent that Kahn and Taylor argue that the Bells lack incentive to leverage their special access market power to harm competition in downstream markets, we explain below that those arguments are contrary to Commission precedent and basic economics. Worse yet, because the Commission has effectively denied competitive carriers unbundled access to loop-transport combinations, thereby requiring competitive carriers to use special access as a substitute, supracompetitive special access rates impede local entry because even competitive carriers that self-deploy their own networks must still lease access to Bell networks as a means to acquire customers prior to building facilities and in order to serve lower volume locations that cannot justify alternative competitive facilities. *See infra* Part IV.

II. THE COMMENTS CONFIRM THAT THE BELLS EXERCISE MARKET POWER OVER SPECIAL ACCESS SERVICES.

11. As we explained in our prior declaration, there are well established economic criteria for determining whether an entity can exercise market power. Perhaps the most important evidence is the extent to which purchasers of the good (or service) in question have alternatives to the supplier in question. Where purchasers have no viable alternatives,

either because there are no currently existing alternative suppliers or because entry is unlikely to be timely or sufficient, the incumbent seller will be able to charge supracompetitive prices for its product or service. Without alternatives, purchasers that demand the good or service in question simply have no choice but to pay the monopoly price to the seller.

12. The firm's pricing behavior can provide empirical evidence regarding market power and its exercise. Because market power is the ability of a firm profitably to sustain prices above the competitive level, then evidence that a firm has been persistently charging prices higher than the pertinent costs of the good or service (including a competitive return on capital) suggests that the firm has market power.[1] Relatedly, market power can ordinarily be inferred when a firm is also able repeatedly to implement substantial price increases absent a material increase in costs or quality (or, is able to lower quality substantially). Such evidence is particularly indicative when the prices that are high and rising relative to economic costs fail to attract new competition and/or entry into the relevant market remains foreclosed.

13. As we show in more detail below, gauged by these criteria, the Bells' market behavior in the provision of special access suggests that the Bells have market power and have been exercising it to the detriment of telecommunications customers. Contrary to Kahn and Taylor's claims, in most instances, even those IXCs that have self-deployed high capacity local networks have no choice but the Bells for special access. And without options, IXCs

[1] *See, e.g.*, U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines* § 0.1 (Rev. Apr. 8, 1997).

have no alternative but to pay what the Bells demand in order to reach their customers. *See infra* Subpart A.

14. Likewise, as a result of the lack of competition, the Bells have used their new-found "pricing flexibility" to raise rates. As noted, the Bells' special access rates for all MSAs where they have been granted pricing flexibility are all higher than in those MSAs where they continue to be subject to price cap regulation. Contrary to Kahn and Taylor's assertions, there is no support for their claim that these increases were necessary to recover cost increases and/or "rationalize" rates. The economic costs of special access services *declined* – due both to increased demand for those services and cost reductions in fiber optic technology – while the Bells' generally increased their prices. *See infra* Subpart B.

15. Notably, Kahn and Taylor agree with us that the Bells' rates should be compared to the economic cost of providing access. Kahn and Taylor are, however, silent as to those relevant costs and the applicable comparisons. In fact, the Bells' special access rates are now two to four times greater than the economic costs of providing the underlying loop and transport facilities. *See infra* Subpart C.

16. The Bells' earnings tell the same story. Since 1996, the Bells' rates of return on special access services have grown every year and now range as high as 50%. Kahn and Taylor are correct that these measures of returns are based on the Bells' historical costs as reported in their ARMIS accounts and that accounting costs are an inferior measure of costs compared to economic costs. But as the Commission and the courts have recognized, the Bells' forward-looking economic costs of providing services over their local networks are much

lower than their historical costs.[2] Thus, the Bells' true return on investment is likely even higher. *See infra* Subpart C.

17. Finally, Kahn and Taylor dispute our prior showing, based on the evidence developed in the *Special Access Performance Standards* proceeding, that the quality of Bell special access services declined as the prices have gone up. Kahn and Taylor do not address any of that evidence but, ironically, cite ARMIS data that purport to show an increase in quality with regard to one quality measure. As we explain below, Kahn and Taylor misinterpret the data, which show a general decline in quality in the provisioning of special access services. *See infra* Subpart D.

A. Evidence Regarding Last Mile Alternatives Available To IXCs.

18. Kahn and Taylor acknowledge that a market power analysis should begin with an assessment of the alternatives available to the purchasers of the goods and services at issue.[3] In this regard, it is important to stress that this assessment must be made in the *relevant market*. As the Bells and their economists have acknowledged, the relevant markets in which to assess competition in the provision of special access are local, point-to-point markets.[4] Surely, the fact that a competitive carrier may have deployed a high

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[2] *Verizon Communications Inc. v. FCC*, 122 S. Ct. 1646, 1666-67 (2002); *Local Competition Order*, 11 FCC Rcd. 15,499, ¶¶ 704-07 (1996). Indeed, the Bells have argued that the economic costs are so much lower than historical costs that this amounts to a taking. *See id.* ¶ 670.

[3] Kahn-Taylor Dec. at 3, 20-25.

[4] Reply Comments of SBC, Shelanski Reply Dec. ¶ 22 (filed in CC Docket 01-338, July 17, 2002) ("the economics of competitive entry differ depending on demographic and geographic features of the market"); Reply Comments of BellSouth, NERA Reply Report ¶ 125 (filed in CC Docket 01-338, July 17, 2002)) ("[T]he focus should appropriately be on the availability of close substitutes to the ILEC's network elements within the geographic area in which local exchange services are provided."); *see also* SBC Reply at 148 (filed in CC Docket 01-338, July 17, 2002) (continued . . .)

capacity network serving Wall Street firms does not prove that there is a viable non-Bell alternative for a carrier seeking access to buildings located in mid-town Manhattan, let alone more distant locations. Thus, the critical issue is whether alternative facilities exist or can be expected to be built in time for the routes needed by carriers.

19. On this critical issue, Kahn and Taylor offer *no* evidence. Instead, they offer a hodge-podge of national data that does not even purport to show the level of competition in any particular relevant market. Even assuming that their figures were accurate – and we understand that they are in many respects inaccurate and overstated[5] – the statistics proffered by Kahn and Taylor do not provide any insight as to whether IXCs have a choice other than the Bell to reach particular customers. They do not address the availability of facilities-based competition in relevant markets, and they do not show that facilities-based entry will offer IXCs alternatives to the Bells in relevant markets where prices significantly exceed competitive levels.

20. For example, Kahn and Taylor cite data regarding the deployment of "local" fiber on a nationwide basis.[6] Our understanding, however, is that the majority of this local fiber is

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("As the Commission has recognized, transport is a point-to-point facility. It is accordingly efficiently deployed . . . where there is sufficient volume between the relevant points."); Reply Comments of Qwest, Farrell Reply Dec. ¶ 29 (filed in CC Docket 01-338, July 17, 2002) ("Given its point-to-point nature, one would expect that dedicated transport would require more of a geographically-focused inquiry . . . ."); Reply Comments of BellSouth, Harris Reply Dec. ¶ 6 (filed in CC Docket No. 01-337, Apr. 22, 2002) ("The geographic scope of the market for broadband access is local.").

[5] *See generally* Selwyn Reply Dec. ¶¶ 30-61.

[6] Kahn-Taylor Dec. at 3, 22-24.

concentrated in a handful of dense urban areas and that often several competitive carriers serve the same high demand routes. The total number of fiber miles may look impressive, but the hard reality is that there is competition in only a handful of locations.

21. Another statistic put forward by Kahn and Taylor is the nationwide number of competitive local carrier "networks."[7] These data do not show whether competitive carriers have deployed bypass facilities at all, let alone the extent to which alternative facilities exist in a particular relevant market. Similarly, national revenue figures,[8] even if they were accurate, say nothing about alternatives for particular types of service in particular relevant markets.

22. Not only are the data relied upon by Kahn and Taylor too aggregated to be meaningful, but their data do not even show that there is actual *bypass* of the Bells. The Commission's pricing flexibility rules deregulate both the Bells' transport *and* channel termination charges.[9] Both inputs are necessary in order to provide special access to customers' premises. Even if there were competition in the provision of transport, to the extent that the Bells control any bottleneck input necessary for special access, such as channel terminations, they can still earn monopoly rents on these bottleneck facilities and use their control to foreclose competition. Thus, in assessing the existence of Bell market power, it is critical to determine whether carriers are able to obtain *all* of the last mile inputs

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[7] *See id.* at 3.

[8] *See id.* at i.

[9] *See* WorldCom at 8-9.

necessary to provide finished services to end-user customers from alternatives other than the Bells.

23. The record evidence establishes that, in the vast majority of instances, IXCs remain dependent upon the Bells for access. Despite an aggressive program to purchase special access from competitive carriers, "non-ILEC vendors have accounted for only approximately 10% of Cable & Wireless's new installations for the year 2002, *down* from approximately 13% in 2001."[10] "Sprint Long Distance . . . continues to rely upon the ILECs for approximately 93% of its total special access needs despite aggressive attempts to self-supply and switch to CLEC-provided facilities wherever feasible."[11] Even AT&T, which has perhaps the largest local network of any IXC, must generally rely on the Bells for last mile high capacity transport.[12]

24. These figures are confirmed by a more granular analysis. Today, AT&T serves approximately 186,000 buildings using special access services. Of that 186,000, approximately 6,700 buildings are served using AT&T's facilities, and another approximately 3,300 buildings are served by competitive LECs.[13] AT&T must rely on the incumbent LECs' special access services for the remaining buildings. In other words, AT&T reaches slightly more than 5% of the buildings it serves by using its own or competitive LEC facilities (in whole or in part). Similarly, WorldCom reports the existence

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[10] Cable & Wireless at 13.

[11] Sprint at 3.

[12] AT&T Petition at 26.

[13] Selwyn Reply Dec. ¶ 17.

of CLEC fiber to only 11% of buildings where it needs special access services.[14] Thus, despite the existence of "scores" of competitive carriers, and the deployment of "thousands" of route miles of fiber, the bottom line remains that AT&T and others need access to Bell facilities in order to reach the overwhelming majority of buildings and businesses.

25. Finally, Kahn and Taylor ignore the substantial barriers to entry that exist in deploying transmission facilities. As one of us has explained in detail in the *Triennial Review* proceeding, entry is unlikely to occur when the competitive carrier faces an absolute cost disadvantage vis-à-vis the incumbent. "This is true even where the incumbent's prices are well above costs. In such a scenario, the incumbent could simply drop its prices below the entrant's costs. The incumbent would remain profitable even at a reduced price, but by setting prices below the entrant's costs the incumbent would make it impossible for the entrant to remain economically viable."[15] The Commission has recognized this point too.[16] Further, even if the incumbent might not respond competitively to a particular entrant's competitive incursion, it might nonetheless collapse the prevailing "price umbrella" if

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[14] WorldCom at 9.

[15] Robert D. Willig, "Determining 'Impairment' Using the *Horizontal Merger Guidelines* Entry Analysis" at 7 ("Willig *Guidelines* White Paper") (attached to AT&T *Ex Parte* in CC Docket 01-338 (Dec. 3, 2002)).

[16] *See, e.g., UNE Remand Order*, 15 FCC Rcd. 3696, ¶ 73 (1999)("[i]f the cost of the alternative element is materially greater than the cost of the corresponding element from the incumbent, the requesting carrier will not be able to provide service at prices that are competitive with the incumbent's prevailing prices"); *Local Competition Order* ¶ 710 ("Congress specifically determined that input prices should be based on costs because this would foster competition in the retail market. Therefore we reject the use of ECPR for establishing prices for interconnection and unbundled elements.").

additional competitors seek to enter. Or, the other competitors might start a price war independent of the incumbent's pricing.

26. The need to enter at a cost structure comparable to the incumbents is particularly strong in this context because the lion's share of the cost of the necessary transmission facilities is sunk.[17] That means that if the competitive carrier does enter but is ultimately unable to offer service profitably, its sunk investment will be stranded and lost.

27. However, because of basic network economics, in most instances competitive carriers simply cannot achieve the requisite cost structure necessary to deploy high capacity fiber loops and transmission facilities used to provide special access services. That is because, as is frequently the case for facilities requiring major portions of fixed and sunk costs, transmission facilities are characterized by huge scale and scope economies.[18] Economies of scale exist because the overwhelming majority of the costs of transmission facilities are fixed, and as a result, the greater the level of traffic that they carry, the lower the per unit costs. And economies of scope exist because transport facilities can share rights-of-way and conduit with loop facilities, thereby reducing the per unit costs of providing services that use both transport facilities and loops together.

28. Given their ubiquitous networks and the fact that they are serving the overwhelming majority of demand, the incumbents benefit substantially from the advantages stemming from scale and scope economies. Nonetheless, in some instances limited entry is possible. In areas where there is particularly high and concentrated demand, competitive carriers

[17] Willig *Guidelines* White Paper at 8, 13.

[18] *Id.* at 9, 13.

have the potential to deploy the same high capacity, fiber optic facilities as the Bells and fill those facilities to reasonably efficient levels of utilization.[19]

29. AT&T's network professionals have precisely quantified the amount of demand that they need in order to obtain a cost structure comparable to the incumbents. That evidence shows that to economically justify the huge fixed and sunk costs of deploying loops/channel terminations, competitive carriers must have at least three DS3s of demand at the potential location.[20] Likewise, AT&T's evidence shows that deployment of transport facilities to a particular point of aggregation only makes sense when there are at least 18 DS3s of traffic available.[21]

30. Thus, economic and engineering theory predict that, regardless of how much time elapses, the Commission can expect to see little, if any, bypass for access facilities used to serve small and medium size businesses (at the DS3 level and below). And that is exactly what

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[19] Even where entry is theoretically economical, it still might not occur because of the inability of competitive carriers to secure the necessary rights-of-way to deploy the facilities. The Bells enjoyed substantial first mover advantages in deploying transmission facilities while competitive carriers, as second movers, are at an enormous disadvantage. As first movers, the incumbent telephone companies received rights-of-way from local governments for underground cables and telephone poles and wires with only minimal transaction costs, because persons in the neighborhood or municipality otherwise would not receive *any* telecommunications services. In contrast, local governments often do not see significant benefits in local competition and are not eager to have multiple companies trenching streets. Similar problems exist with regard to building access. Building owners and landlords understandably welcomed and accommodated incumbent carriers that promised to bring, for the first time, telecommunications facilities to their properties, but, we understand, often view granting building access to competitive carriers as a nuisance.

[20] *Ex Parte* Letter from Joan Marsh (AT&T) to Marlene Dortch, CC Docket No. 01-338, Att. B (Nov. 25, 2002).

[21] *Id.*, Att. A.

AT&T's data show. AT&T obtains virtually all (93%) of its DS1-level transport from incumbent carriers, and, although AT&T has greater success in bypassing the incumbents with regard to DS3-level access, AT&T stills uses the incumbent carrier for 65% of its DS3 level access.[22] Further, these same economic considerations also mean that competitive carriers may not be able to build to reach even the highest demand customers to the extent those customers are located outside of dense urban areas or because of right-of-way access issues. Again, AT&T's data confirm this view. For those few locations that can justify at least an OC3-level facility, AT&T still must frequently rely on the Bell (albeit, less often than with regard to DSn level services).[23]

31. It is also important to recognize that DSn level services constitute a majority of the market of special access services. According to AT&T's experts, the majority of its dedicated access expense is for DS1- and DS3-level services.[24] Public filings by the Bells are in accord with this estimate. For example, SBC-Ameritech reports that DS1 services account for 60% of its total special access revenues.

32. Looking at the data on a building basis tells the same story. As noted, AT&T estimates that there are about 186,000 buildings where it requires special access services. However, we understand that in only a small fraction of those buildings does AT&T have sufficient multiple DS3s of demand to even potentially support bypass facilities. Further, we understand many of these buildings are located in MSAs where AT&T does not even have

[22] Stith Dec. ¶ 12.

[23] *Id.*

[24] *Id.*

a local network, or are located at such a great distance from AT&T's local networks that bypass would require prohibitively costly network expansion.[25]

B. The Bells' Response To Pricing Flexibility.

33. The Bells' market behavior after obtaining pricing flexibility strongly suggests that they have market power in the provision of special access. In the past, the Bells argued that pricing flexibility was necessary to lower rates in order to meet emerging competition. Typical of these claims were the Bells' statements to the court of appeals in defense of the *Pricing Flexibility Order*. "[T]he LECS themselves face truly irreparable losses . . . if they are deprived of the pricing flexibility that they need to respond to competition. If they cannot reduce their rates in lower-cost areas and offer the same volume and term discounts as their competitors, LECs cannot recover their lost revenues."[26]

34. The reality, however, is that the limited competition that the Bells face has not induced a competitive response. In fact, the rates in those MSAs where the Bells have obtained Phase II relief are generally *higher* than for MSAs in those jurisdictions where they have not yet gained Phase II relief. This cannot be explained as "rate rationalization" in light of the fact that the MSAs where relief has been granted tend to be the most urban areas in the country. The economic costs in these more urban areas are likely to be *lower* because of the ability

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[25] WorldCom provides a comparable analysis in its comments. *See* WorldCom at 9 ("It is not economically viable for CLECs to extend their fiber networks to any of the hundreds of thousands of buildings that require only a single DS3 or a handful of DS1s. Phase II relief is overbroad because it allows the ILECs to escape price cap regulation for *all* channel terminations services, even the lower capacity DS1 and DS3 circuits for which CLEC alternatives do not exist today and are unlikely to exist in the future").

[26] Brief of Intervenors in Support of the FCC, Nos. 99-1395, 99-1404, and 99-1472, at 11 (D.C. Cir. Aug. 4, 2000).

to concentrate relatively greater demand on relatively shorter routes. Thus, the Bells' pricing structure is the *opposite* of what one would expect to see in competitive markets – rates are higher where costs are lower.

35. Another aspect of the Bells' pricing behavior is contrary to Kahn and Taylor's hypothesis that competition is constraining the Bell's pricing behavior. In those MSAs where the Bells have obtained pricing flexibility, they have generally either *raised* rates or held the existing rates.[27] In not a single Phase II MSA have they lowered rates. For example, Verizon increased its month-to-month DS1 rates as much as 15% (and its month-to-month DS3 rates by 6%) in *every* MSA in which it won Phase II pricing flexibility, even in large cities such as New York and Boston where the presence of competitors is greatest.[28] Similarly, BellSouth raised its month-to-month DS3 rates by almost 9%, and its DS1 rates by approximately 8%, in each of the MSAs in which it received Phase II pricing flexibility, including such large cities as Atlanta and Miami.[29] Overall, Sprint estimates that where pricing flexibility has been granted, DS1 special access rates increased an average of 9.8% and DS3 rates increased an average of 5.6%.[30] In competitive markets, one would expect to see the opposite result because the per unit costs of providing special access have *decreased*

[27] AT&T Petition at 11-12.

[28] *Id.* at 12.

[29] *Id.*

[30] Sprint at 7.

substantially due in part to technological improvements in fiber optic electronics and scale economies and increased demand for special access services.[31]

36. We recognize, of course, that the barriers to entry are not fully blocking entry everywhere: competitive carriers have been able to deploy some facilities, in some markets, serving some routes. And we understand that where IXCs have a choice of multiple competitive carriers, these competitive carriers compete fiercely on price. But, as the data cited above show, the Bells have not lowered their prices in response. The most logical explanation for this is that the Bells have disincentives to price discriminate. If the Bells were to lower prices in the handful of instances where they do face competition, it would put pressure on them to lower rates in the majority of instances where they do not face competition. Evidently, the Bells have made the determination that it is more profitable for them to keep prices uniformly high and cede some customers to competitive carriers rather than to risk narrowly selective reductions that would likely lead to regulatory pressure to reduce prices on an MSA-wide basis.

37. This can be seen most clearly with regard to the Bells' "response" to "competition" for OCn level services. As noted, this is the level of service that has seen the greatest deployment of alternative facilities by competitive carriers. Nonetheless, the rates for these services in Phase II MSAs are generally the same as, or in some instances are higher than, the rates for the same services in non-Phase II MSAs. In contrast, where multiple competitive carriers exist, they price well below the Bells' rates for comparable services, offering rates that can be as low as half of what the Bells typically charge. Similarly, as

[31] *See* Selwyn Reply Dec. ¶¶ 74-78 (documenting decline in per-unit special access costs).

Mr. Selwyn explains in greater detail, the Bells have entered into very few contract tariffs, which were the instruments that the Commission envisioned the Bells using to meet competition.[32]

38. Although the Bells have not lowered their overall rates, or even offered targeted reductions to customers facing competition, they have adjusted the rates for components of special access. To the extent that facilities bypass has occurred, it has been largely at the transport level. As discussed, IXCs, still require channel terminations/loops in order to originate/terminate traffic. Even if some of the inputs used to provide special access are competitive, to the extent that Bells control any bottleneck input necessary for special access, they can still collect monopoly rents and control the market by lowering prices for inputs where there is competition while raising prices for inputs where there is no competition.[33]

39. That is precisely what we see here. As Mr. Selwyn shows, the Bells' special access price increases have been driven primarily by increases in channel termination prices.[34] For example, as a result of its price increases, Verizon now charges $2,911.37 per month for channel terminations in the highest Phase II MSAs density zones in its Southern territories, compared to $1,700.96 per month in price cap areas.[35] In contrast, where competition for

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[32] Selwyn Reply Dec. ¶¶ 12, 14-15.

[33] The almost complete absence of channel termination competition is also reflected in the handful of contract tariffs entered into by the Bells. To the extent these contract tariffs offer discounts, the lower rates are generally for transport and not for channel terminations. *Id.* ¶ 14.

[34] *Id.* ¶¶ 9-10.

[35] *Id.* ¶ 9.

"entrance facilities" that connect a wire center to an IXC point of presence is most developed, there is very little difference between the rates charged by Verizon in Phase II and non-Phase II MSAs.[36] Similarly, transport rates have remained largely unchanged in Phase II areas.[37]

40. Kahn and Taylor do not deny any of these facts. Instead, they suggest that the increased prices for special access may be the result of increased demand for this service.[38] According to Kahn and Taylor, where there is an "upward sloping" supply curve, an outward shift in the demand curve (*i.e.*, an increase in demand) will result in higher prices because the costs of supplying the additional demand are higher. This argument, while theoretically correct, does not apply to the provision of special access.

41. Kahn and Taylor repeatedly emphasize in the pages immediately preceding this argument that special access is characterized by significant scale economies. We agree. But that means that the average cost curve is *downward* sloping – *i.e.*, an increase in demand would lead to *lower* per unit costs. And consistent with this theory, the evidence shows that the Bells per unit costs have, in fact, declined.[39] Thus, there is no reason to believe that the marginal cost curve is upward sloping, nor that a Bell could be expected to price at marginal cost along a competitive supply curve. These facts devastate the Bells' position. They confirm that the Bells have held prices steady or increased them even as the

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[36] *Id.*

[37] *Id.* ¶ 10.

[38] Kahn-Taylor Dec. at 14.

[39] Selwyn Reply Dec. ¶¶ 76-78.

underlying costs of providing special access services have fallen. In competitive markets, the opposite result would obtain.

42. Kahn and Taylor also proffer this "upwards sloping supply curve" theory as the explanation for why special access revenues per special access line fell from 1996 to 2001. Kahn and Taylor misinterpret the data. The "fact" that revenue per line decreased from 1996 to 2000 does not support the Bells' arguments because those declines were due to the fact that the Bells' special access rates were subject to price caps, which mandated rate reductions. Notably, Kahn and Taylor's own chart shows a substantial increase in revenue per line from 2000 to 2001, which coincides with the advent of Phase II pricing flexibility.[40] Further, as Mr. Selwyn explains, Kahn and Taylor understate the true level of revenue increases during this period by determining revenues on a DS0 equivalent basis.[41] Finally, Mr. Selwyn shows that the Bells' per unit *costs* decreased substantially over this time period resulting in a substantial gain in earnings.[42]

C. The Bells Increasing And Excessive Earnings On Special Access.

43. Although it is difficult empirically to identify a single point of demarcation at which a rate-of-return can be deemed "supracompetitive," the Bells' special access profits generally evidence the absence of effective competitive constraints, with each way these earnings are measured. Indeed, the Bells' returns on special access have increased every year since

[40] Kahn-Taylor Dec. at 16.

[41] Selwyn Reply Dec. ¶ 78.

[42] *Id.* ¶ 77.

1996 and, as of the end of 2001, ranged from a low of over 20% (Verizon) to over 50% (SBC).

44. Kahn and Taylor respond that these statistics cannot be given any weight because the returns are calculated using costs derived from the Bells' ARMIS accounts. According to Kahn and Taylor, use of accounting costs is inappropriate because the Commission's accounting rules arbitrarily assign costs to services in a way that is not cost-causative and "the resulting costs are not economic costs."[43] Kahn and Taylor have helpfully narrowed the debate because we agree that the more economically appropriate measure of Bell earnings is their return on *economic costs* (as opposed to ARMIS accounting costs). The Bells' economic returns, however, are even higher than their returns on historical costs. Moreover, although we believe that economic costs is the correct standard, we believe that, used appropriately, accounting costs can be used to provide a conservative benchmark for assessing whether the Bells' special access earnings are indicative of monopoly power.

45. *The Bells' Special Access Rates Are Well In Excess Of Any Reasonable Measure Of Economic Costs.* Here, the Bells seem to advocate measuring the reasonableness of their special access charges on the basis of economic costs as opposed to their ARMIS accounting costs. In the past, the Bells have repeatedly argued that their rates should not be set on the basis of economic costs because such a standard would not allow them to recover their much *higher* historical costs.[44] The reason why the historical costs of telecommunications services and facilities are higher than the economic costs is straight-

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[43] Kahn-Taylor Dec. at 9.

[44] *See, e.g., Local Competition Order* ¶ 670.

forward. Not only do the Bells' historical accounts reflect inefficiently incurred costs (*e.g.*, failures to purchase inputs from the lowest cost supplier, use of sub-optimal network architecture), but the per-unit costs of high capacity transport continue to decline as a result of advances in fiber optic technology.[45] In other words, because of technological advances, the costs of building a network that serves existing levels of special access demand are lower today than they were even last year, and are much lower than they were several years ago when the Bells incurred the lion's share of costs recorded in their ARMIS accounts.

46. As the Commission has repeatedly held, economic costs are, in general, long run incremental costs, and the economic costs of network facilities in particular should be calculated using the Commission's TELRIC standard. The Bells have acknowledged, as they must, that their special access prices are well in excess of TELRIC.[46] Indeed, as Mr. Stith showed in his initial declaration, special access services in many MSAs are priced as high as four times the long run incremental cost of the underlying facility. Thus, the Bells' special access rates flunk the very economic cost standard that they now advocate.

47. Nonetheless, Kahn and Taylor try to avoid the logic of their own argument by claiming that the Commission's TELRIC standard is not the appropriate measure of long run incremental costs in this context. This argument is a red herring. The Bells are earning supracompetitive profits even on the embedded cost base, and their special access rates are

[45] *See* Selwyn Reply Dec. ¶ 77 (qualifying cost decreases).

[46] Comments of BellSouth at 3 (filed in CC Docket No, 96-98, Apr. 5, 2001); Comments of Qwest at 7 (filed in CC Docket No. 96-98, Apr. 5, 2001).

multiple times TELRIC. By any plausible measure of economic costs, the Bells are clearly earning supracompetitive profits.

48. In all events, Kahn and Taylor's specific attacks on TELRIC here are misplaced. First, they observe that "in the face of significant fixed and common costs, prices systematically exceed marginal costs."[47] No one is claiming that the Bells' special access rates should be set on the basis of marginal costs (except perhaps Kahn and Taylor themselves in their argument based on pricing in accordance with their imagined upwards sloping supply curve). By definition, TELRIC is a measure of *total incremental* costs, not marginal costs.[48] Appropriately set, TELRIC includes the full costs to construct, maintain, and operate all the facilities used to provide special access.[49]

49. In the alternative, Kahn and Taylor claim that TELRIC is an improper baseline because special access rates properly include common costs in addition to direct costs.[50] We agree that, in assessing the competitiveness of special access rates, one should consider not only the direct costs of providing the underlying facilities used to provide special access, but also a "reasonable" share of common costs. The Commission's TELRIC methodology, however, appropriately includes such a measure of common costs.[51]

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[47] Kahn-Taylor Dec. at 10.

[48] *Local Competition Order* ¶ 675.

[49] *Id.*¶ 690 ("The increment that forms the basis for a TELRIC study shall be the entire quantity of the network element provided").

[50] Kahn-Taylor Dec. at 9-12.

[51] *See Local Competition Order* ¶ 694 (given the existence of common costs, "setting the price of each discrete network element based solely on the forward-looking incremental costs directly attributable to the production of individual elements will not recover the total forward-looking (continued . . .)

50. Finally, Kahn and Taylor are wrong in claiming that TELRIC is flawed because it measures the efficient costs of providing the service, not the "actual economic" costs of the individual Bells.[52] We and Kahn and Taylor, as well as the Commission, have been over this ground many times. It suffices to say that in declining cost industries the measure of costs to which prices converge in perfectly contestable markets – whether wholesale markets or retail markets – is forward-looking economic cost and not the "actual" costs of any particular firm.[53] Thus, to the extent that any firm can profitably charge more than an efficient provider, it is, by definition, earning supracompetitive prices.[54]

51. *Used Appropriately, The Bells' Accounting Costs Provide A Conservative Benchmark For The Economic Costs Of Providing Special Access.* As noted, we do not dispute Kahn and Taylor's assertion that the best way to check the reasonableness of the Bells' special access rates is to compare them to the "economic costs" of the underlying facilities used to provide special access services. But that does not necessarily mean that accounting measures

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(. . . continued)
costs of operating the wholesale network. Because forward-looking costs are consistent with our forward-looking, economic cost paradigm, a reasonable measure of such costs shall be included in the prices for interconnection and access to network elements.").

[52] Kahn-Taylor Dec. at 9-10.

[53] *See Local Competition Order* ¶ 679 ("a pricing methodology based on forward-looking costs simulates the conditions in a competitive marketplace."); *Verizon*, 122 S. Ct. at 1668 (TELRIC mimics prices that would result in "competitive markets").

[54] David Pierce, THE MIT DICTIONARY OF MODERN ECONOMICS 310, 415 (1994). In the alternative, one could read Kahn and Taylor as arguing that application of the TELRIC standard results in cost determinations that could not reasonably be achieved in any "real" competitive market. Whatever the merits of this argument, it has been expressly rejected by the Supreme Court. In fact, as the Supreme Court observed, the Commission's TELRIC standard in many important ways results in costs *above* "perfectly" efficient levels. *See Verizon*, 122 S. Ct. at 1669-70.

cannot be used under appropriate circumstances as a source of inferences about whether the Bells are earning excessive returns. Given that the historical costs of special access are in excess of economic costs, a showing that the Bells are earning excessive returns on appropriately calculated historical costs *a fortiori* establishes that they are earning excessive rates on economic costs.

52. To be sure, we recognize that application of an accounting cost standard requires the allocation of certain costs and that, to the extent that such allocations are biased, the resultant cost determinations will be flawed. Here, however, according to Mr. Selwyn, there are good reasons to believe that, if anything, the Commission's accounting rules overstate special access costs and thereby understate the Bells' rate of return.[55]

53. Notably, although they argue that in theory there are potentially numerous ways in which the Commission's accounting rules could under-allocate costs or over-allocate revenues to special access (thereby leading to an overstatement in the Bells' rates of return), Kahn and Taylor provide only a single specific instance of such bias. According to Kahn and Taylor, special access accounts include costs and revenues attributable to DSL service, and the Bells' DSL services are earning revenues well in excess of their costs.[56]

54. Although we understand that there are reasons to doubt the factual underpinnings of this claim, the impact of this potential mis-allocation is minimal. According to Mr. Selwyn's calculations, even if one were to eliminate all of the revenues that the Bells say are

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[55] Selwyn Reply Dec. ¶¶ 62-73. Indeed, the Commission's 1999 audit of the Bells' property records revealed that the Bells could not account for approximately $5 billion of plant recorded in their books. *Id.* ¶ 74.

[56] Kahn-Taylor Dec. at 14-15.

attributable to DSL but leave in all of the costs of DSL, the resultant rates of return would only be slightly diminished from those calculated by AT&T.[57] Further, in the case of SBC – which enjoys the highest rate of return on special access – this "error" has no impact at all because SBC had established a separate advanced services affiliate and did not include DSL revenues in its ARMIS special access revenues.[58]

55. Finally, Kahn and Taylor argue that AT&T's "earnings" evidence does not establish that the Commission's *Pricing Flexibility Order* is the cause of the over-earning because earnings were increasing before pricing flexibility was granted and during the initial stages of implementation.[59] This argument is flawed on two levels.

56. First, and most fundamentally, it misapprehends AT&T's position. AT&T's position is not that the prior regulatory regime worked adequately and that it was only the promulgation of pricing flexibility that freed the Bells to exercise market power. Rather, AT&T's argument is that the prior regime was flawed and that pricing flexibility only made things worse. Thus, even if Kahn and Taylor were correct that AT&T's data show that the Bells were over-earning prior to pricing flexibility and that the current regime did not impact the extent to which the Bells were over-earning, that does not undermine AT&T's Petition and the clear need for regulatory reform.

57. Second, AT&T did demonstrate causation. Kahn and Taylor simply ignore AT&T's showing, discussed above, that in those MSAs where the Bells have been granted pricing

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[57] Selwyn Reply Dec. ¶¶ 67-68.

[58] *Id.* ¶ 66.

[59] Kahn-Taylor Dec. at 17-20.

flexibility, they have generally either raised prices or held prices steady, despite declines in costs. Similarly, the Bells' special access rates in Phase II MSAs are generally higher than in those MSAs where they have not been granted pricing flexibility. This pricing behavior clearly establishes a nexus between the grant of pricing flexibility and the exercise of market power by the Bells.

D. While Special Access Rates Have Increased, Quality Has Decreased.

58. At the same time that special access prices and demand have gone up, the quality of special access services has gone down. In the Special Access Performance Measures Proceeding, AT&T, other IXCs, and end users have all come forward with evidence showing a decline in the quality of the Bells' provisioning of special access in the last few years. In addition, the commenters show that competitive carriers have been willing to provide performance guarantees for special access services while the Bells will not even negotiate on this topic.[60] In competitive markets, companies cannot increase prices, decrease quality, and experience increased demand.

59. Kahn and Taylor do not respond directly to any of the evidence put forward in the *Special Access Performance Measures* proceeding, but instead, ironically, claim that ARMIS data show an increase in special access quality. In his declaration, Mr. Selwyn disproves that claim. As Mr. Selwyn shows, Kahn and Taylor's conclusion is based on trouble reports per voice grade equivalent line as opposed to the more relevant measure of trouble reports per order.[61] Based on the correct measure, the Bells' performance is much more varied, and

[60] Cable & Wireless at 16-17.

[61] Selwyn Reply Dec. ¶ 79.

indeed, when one removes Ameritech, average performance has been steadily declining during the period 1998-2001.[62]

III. THE BELLS' OPPs AMPLIFY THE BARRIERS TO FACILITIES-BASED COMPETITION.

60. Kahn and Taylor admit that discounted offerings can be used to prevent entry by competitors, and, indeed, that Professor Kahn has repeatedly taken this position in his professional writings. Nonetheless, Kahn and Taylor say that the Commission should not be concerned about this problem here because the Bells' OPPs are generally available offers.[63]

61. Kahn and Taylor simply ignore the economic reality of the situation. To be sure, if IXCs, CMRS providers, and other carriers had the choice between a competitively priced month-to-month rate and an OPP that offered lower rates, but required a long term commitment, no policy concerns would be raised about impacts on competition. To the extent that a carrier was unwilling to make a long term commitment, it could still obtain access at reasonable prices by purchasing service on a month-to-month basis.

62. But here, carriers do not have the choice of a competitively priced month-to-month rate. Rather, as we have shown, the Bells' base rates are priced well in excess of costs. As a result, the Bells' pricing strategy puts special access customers between a rock and a hard place. They can obtain discounts off the Bells' excessive base rates only by agreeing to OPPs that contain long terms and stiff termination penalties. In short, the reason why IXCs,

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[62] *Id.*

[63] Kahn-Taylor Dec. at 29-30.

CMRS providers and other carriers would allow themselves "voluntarily" to be "subjected to monopolistic exploitation"[64] is because the only alternative is month-to-month terms with much higher rates.[65]

63. OPPs are particularly likely to amplify barriers to facilities-based competition when they require that carriers commit to sending all, or virtually all, their traffic to the Bells for a sustained time period as a condition for lower rates. These exclusivity requirements prevent the carrier from sending traffic to any new or other facilities-based competitor of the Bell, even if the carrier otherwise were to meet the Bell's minimum volume commitments.[66] In this way, the opportunities for a facilities-based competitor are rendered significantly more constricted and unprofitable than would be the result of just the market's more naturally endemic barriers to competition.

64. The OPP mechanisms also allow the Bells more-fully to exploit the somewhat constrained market power that they have in the Phase II MSAs where they are still subject to price cap regulation. These OPP exclusivity requirements are *state-wide* commitments. Thus, in order for a carrier to mitigate the impact of the high Bell rates in Phase II MSAs, that carrier must also agree to send all of its traffic from both the Phase II MSAs and the non-Phase II MSAs in that state to the Bell for the full term of the agreement.

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[64] Kahn-Taylor Dec. at 33.

[65] *See* AT&T Wireless at 6 (in the absence of competition, "the only ability AWS has to mitigate special access costs is by entering into long-term volume commitments with the ILECs in order to obtain pricing discounts.").

[66] Arch Wireless at 4; XO at 5, 7.

65. Not only do the OPPs ensure the Bells of a steady stream of special access revenues at supracompetitive prices, but by locking up major customers, the Bells' OPPs can magnify the suppression of facilities-based competition caused by the natural market barriers.[67] As we explained, because transmission facilities involve sunk costs and economies of scale, competitive carriers cannot simply deploy facilities and hope to gain customers. Rather, they must have a reasonable assurance of attracting the traffic necessary to support the same type of high capacity facility deployed by the incumbent. To the extent that incumbents have tied up the largest customers with long term contracts, competitive carriers will be unable to anticipate generating the level of revenues necessary to justify facilities deployment.

IV. THE BELLS CAN EXPLOIT SPECIAL ACCESS MARKET POWER TO HARM COMPETITION IN DOWNSTREAM MARKETS.

66. In our prior statement, we explained how the Bells have the ability to use market power over special access to impede long distance competition on the merits. In response, Kahn and Taylor deny that the Bells have any incentive anticompetitively to price-squeeze in downstream retail markets.[68] We disagree. By charging exorbitant special access rates to IXCs, for example, the Bells can implement a classic anticompetitive price squeeze, and thereby raise their rivals' costs in a disabling fashion. If IXCs try to pass these monopoly costs along to their customers, they risk losing customers to the Bell's long distance

[67] *See* AT&T Wireless at 6; WorldCom at 12.

[68] *See* Kahn-Taylor Dec. at 35. In this regard, Kahn and Taylor also claim that the Bells do not have an incentive to price squeeze because "it entails the [Bell's long distance] affiliate sacrificing profits for some period of time." *Id.* This claim should be rejected out of hand. Firms with separate subsidiaries engage in joint profit maximization – *i.e.*, they maximize overall profits, not the profits of particular corporate entities.

services that have last mile access available at economic costs. If they do not attempt to pass along the monopoly costs, they face artificially excessive costs that threaten to outrun revenues both in the short and long runs. This is not just our view, but the stated view of the Commission as well:

> Absent appropriate regulation, an incumbent LEC and its interexchange affiliate could potentially implement a price squeeze once the incumbent LEC began offering in-region, interexchange toll services. . . . The incumbent LEC could do this by raising the price of interstate access services to all interexchange carriers, which would cause competing in-region carriers to either raise their retail rates to maintain their profit margins or to attempt to maintain their market share by not raising their prices to reflect the increase in access charges, thereby reducing their profit margins. If the competing in-region, interexchange providers raised their prices to recover the increased access charges, the incumbent LEC's interexchange affiliate could seek to expand its market share by not matching the price increase. The incumbent LEC affiliate could also set its in-region, interexchange prices at or below its access prices. Its competitors would then be faced with the choice of lowering their retail rates for interexchange services, thereby reducing their profit margins, or maintaining their retail rates at the higher price and risk losing market share.[69]

Thus, the Bells will be able to gain market share while charging excessive rates to end-users, not because they are more efficient or offer higher quality, but rather because they control bottleneck local facilities, and use that control to suppress the strength of competition from IXCs.

67. At the end of the day, Kahn and Taylor do not deny the ability of the Bells to use special access anticompetitively to raise rivals' costs, but claim only that the Bells will not forego any short terms profits by setting prices that reflect the Bells anticompetitive cost advantage. Instead, they argue that the Bells will generally set their prices at a level that

[69] *Access Reform Order*, 12 FCC Rcd. 15982, ¶ 277 (1997).

reflects the higher costs that their rivals incur (due to having to pay the Bells' supracompetitive access charges). That may be true, but the fact that the Bells may find it profit maximizing to set prices for competitors and customers that reflect monopoly rents is hardly a compelling reason for the Commission to remain on the sidelines. As the D.C. Circuit has recognized, price squeezes are contrary to the public interest even if the Bells do not "absolutely preclude" competition by setting a retail rate that is below the price that they are charging[70]

68. Kahn and Taylor ignore the fact that, if the spread between a Bell's economic costs and its special access rates is sufficiently large, the Bell could set a retail rate sufficiently low that it would be impossible for IXCs to compete. Thus, even though this may result in the loss of profits in the short term, over the long term it might allow the Bell to dominate that and related markets, and thereby recoup any lost profits by charging monopoly prices to retail customers.[71]

69. Ultimately, we do not need to guess at whether the Bells will act on their incentives because there is compelling evidence that they have attempted anticompetitively to price-squeeze their competitors. In CC Docket No. 01-337, AT&T provided sworn testimony that there

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[70] *WorldCom Inc. v. FCC*, 308 F.3d 1, 10 (D.C. Cir. 2002) (quoting *Anaheim v. FERC*, 941 F.2d 1234, 1238 (D.C. Cir. 1991)) (it is against the "public interest" for the Commission to permit any price squeeze that "exert[s] *any* anticompetitive effects," even if it does not "*absolutely* preclude" competition) (emphasis in original).

[71] We note that, to the extent that existing price cap regulation constrains Bell market power, a Bell would have incentives to leverage its local dominance into unregulated long distance markets. This price squeeze strategy also makes sense because eliminating IXC competition helps to entrench the Bells' local monopolies. IXCs are among the potentially most significant entrants into the Bells' local markets.

are several areas where the Bell special access charges incurred by AT&T are higher than the *retail* price the Bell is charging customers directly for its intraLATA frame relay or ATM ports.[72] In some areas, Bell access charges by themselves exceed the prices that AT&T would have to charge in order to be competitive with the ILEC retail frame relay and ATM prices by as much as 50%.[73]

70. The comments also show that wireless carriers are extremely vulnerable to predation by the Bells. CMRS providers require high capacity transport to connect the cell sites that originate and terminate calls to centrally located mobile switch centers ("MSCs") and to interconnect those MSCs to the landline network.[74] Further, these cell sites are distributed widely throughout the United States in order to meet increasing demand for cell service outside of urban areas.[75] Paging and messaging services also require high capacity transport links.[76]

71. Like IXCs, CMRS providers generally have no alternative other than the Bells with regard to high capacity transport. AT&T Wireless reports that over 90 percent of its transport costs "remunerate ILECs for special access services."[77] Similarly, Nextel Communications has stated that it has 30,000 high capacity circuits connecting its 15,000 cell sites and its

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[72] *See* Comments of AT&T, Benway Dec. ¶ 13. (filed in CC Docket 01-338, March 1, 2002).

[73] *See id.*

[74] *Ex Parte Letter* from Doug Bonner (T-Mobile) to Marlene Dortch, at 1 (Jan. 6, 2003) ("T-Mobile *Ex Parte*").

[75] *Id.*; Arch Wireless at 3.

[76] *Id.* at 2.

[77] T-Mobile *Ex Parte* at 2; AT&T Wireless at 2-3.

MSCs and incumbent central offices, and that 85% of these high capacity circuits are purchased from incumbents despite its attempts to identify alternative suppliers. And T-Mobile says that it uses the incumbents' special access services for 96% of its high capacity circuits.[78]

72. The Bells own, or have substantial ownership interests in, CMRS providers (as well as paging and message services providers). Thus, for the reasons stated above, the Bells could use their control over bottleneck transport facilities to price squeeze and impede wireless competition on the merits. Wireless carriers are particularly vulnerable to Bell predation because dedicated transport is their single biggest network operating cost.[79] At a minimum, a sizeable percentage of the Bells' monopoly charges are passed along to wireless users. This not only directly harms consumers, it reduces the overall consumption of wireless services below efficient levels.

73. Lastly, inflated special access rates impede local competition. As one of us has explained in detail in the *Triennial Review* proceeding,[80] even in those limited instances where facilities deployment can be justified, competitive carriers still need access to Bell networks. This is so for two reasons. First, because of the enormous sunk costs involved in deploying transmission facilities, competitive carriers will not risk deploying networks without assurance of having customers to pay for them. At the same time, customers are not willing to commit to service and then wait months for the facilities to be deployed.

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[78] T-Mobile *Ex Parte* at 3.

[79] AT&T Wireless at 4.

[80] *See generally* Reply Comments of AT&T, Willig Reply Dec. (filed CC Docket 01-338, July (continued . . .)

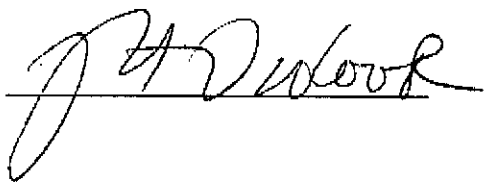
Thus, competitive carriers use access to Bell networks as a "bridge" that allows them to acquire the body of customers and then build. Second, access to Bell networks can be used to aggregate demand from several low volume locations to a "hub" that has sufficient traffic to justify a facilities deployment.

74. In theory, cost-based unbundled loops-transport combinations should be available to perform these functions. But, we understand that due to the Commission's use and co-mingling restrictions, unbundled loop-transport combinations are rarely available and that competitive carriers instead can gain access to Bell last mile transmission facilities only by purchasing special access services. Thus, so long as special access services are priced significantly above cost, competitive carriers face a dilemma. They can either forego purchasing special access and diminish their ability to construct local networks. Or they can use special access services to "fill in" their networks in the manner described above, but internalize a cost structure that puts them at a competitive disadvantage with the Bells.

(. . . continued)
17, 2002).

VERIFICATION

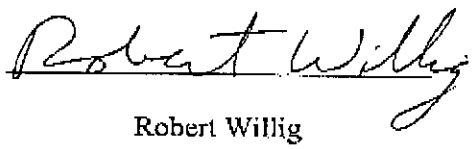
I, JANUSZ ORDOVER, declare under penalty of perjury that the foregoing is true and correct. Executed on January 18th 2003.



VERIFICATION

I, Robert Willig, declare under penalty of perjury that the foregoing is true and correct.

Executed on January 22, 2003.



Robert Willig